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THE SECRET OF INCREASED COMPETITIVENESS: HIGHER PRODUCTIVITY

INTRODUCTION

The buzzword for today is "competitiveness." American businesses are unable to hold their own against foreign firms, the argument goes, because they have lost their competitive edge. For this reason, it is said, U.S. exports are flat, while imports take a growing share of the U.S. market.

Interest in U.S. competitiveness is not new. In December 1984, the President's Commission On Industrial Competitiveness, chaired by Hewlett-Packard President John A. Young, issued the two volume report Global Competition[1] and several supplements that focused on productivity and entrepreneurship. These reports, largely ignored at the time of their release, are now receiving considerable public attention. In conjunction with the National Association of Manufacturers, Young has created a Council On Competitiveness to further the Commission's recommendations. Another group looking into this is the Congressional Caucus On Competitiveness, a bipartisan group that includes Senator John Chafee, the Rhode Island Republican, and Senator Max Baucus, the Montana Democrat. Competitiveness also is high on the agenda of the Democratic Leadership Council, a group that

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1. Global Competition: The New Reality, Volumes I and II, The Report of the President's Commission on Industrial Competitiveness (Washington, D.C.: U.S. Government Printing Office, January 1985). Also see supplements: Edward V. Regan and Bruno J. Mauer, co-chairs, Innovations in Industrial Competitiveness at the State Level (SRI International, December 1984) and Regan and Mauer, Entrepreneurship and Its Impact on the U.S. Economy (Center for Entrepreneurial Studies at New York University, December 1984.

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includes former Virginia governor Charles Robb, Florida Senator Lawton Chiles, and Missouri Representative Richard Gephardt.

Despite the growing fascination with competitiveness, there is much confusion concerning the meaning of the concept. A competitive economy is not simply one that outsells its foreign competitors in various manufactured products. The objective of a competitive economy and of U.S. economic policy in general should be to secure a rising standard of living for all Americans, the most possible choices for consumers, and maximum employment opportunities. If a proposed policy meant to increase America's competitiveness is detrimental to these goals, it should be rejected as contrary to the national interest. The only way to reach these goals is by increasing American productivity.

Many mistakenly see a trade deficit and an increased number of service jobs as signs of slipping competitiveness. In fact, neither trend necessarily indicates weakness. Admittedly, over the last several decades, productivity has grown more slowly in America than in most other countries. And various industries, such as autos and steel, have been slow to modernize. Foreign firms, producing for less cost, now compete successfully in markets once dominated by U.S. goods.

But in recent years this disturbing trend has begun to reverse. Partly because of the challenge of foreign competition as well as tax cuts and deregulation, overall U.S. productivity is rising as many U.S. firms cut their costs of production. Even without government action, this improvement in productivity probably will continue. Yet an understanding of the various factors that have hindered U.S. productivity growth in the past can help national leaders formulate policies that would hasten this trend and avoid policies that would reverse it.

Labor-management relations, for instance, often have been contentious, in the long run harming both labor and business. Excessive wage demands have undermined productivity in many sectors. Business is also to blame. Many U.S. firms have been shortsighted, complacent, and too inattentive to the improvements in marketing and technology needed to maintain a competitive edge. And government regulations and tax policies often have fostered and reinforced these bad habits, discouraging innovation while driving up the cost of doing business.

Trade protectionism and national industrial planning will do nothing to change the basics of American competitiveness. Such policies would be counterproductive. There are federal government actions, however, that would be helpful. First, labor laws that prohibit certain kinds of labor-management cooperation should be repealed. Second, business deregulation should should be accelerated. For example, antitrust laws that prohibit American

business cooperation in the face of foreign competition should be repealed. And third, the cost of capital should be lowered by cutting federal spending to free up funds for productive uses, and by eliminating the double taxation of corporations.

WHAT IS COMPETITIVENESS?

Although the subject of much public discussion, the term "competitiveness" is not readily understood. It is often defined too narrowly, simply as the ability of particular U.S. goods to sell in the market when competing with foreign goods. While this is an important aspect of competitiveness, any reform suggested to aid American businesses through improved competitiveness must be judged in terms of the three ultimate goals of U.S. economic policy.

First, as the Young Commission on Industrial Competitiveness notes, "Competitiveness means a high standard of living and growing wealth...." With a competitive economy, Americans are able to purchase more in real terms with their money, and purchasing power is on the rise. Policies that might help certain industries but lower the overall American standard of living only weaken the economy.

Second, a competitive economy produces a comparatively wide choice of goods and services to satisfy consumer demands. More variety is available, such as a very broad selection of automobiles or refrigerators. The quality and durability of goods increases to meet consumer demands. New products, such as video cassette recorders or home computers, quickly become available at prices that many consumers can afford. And new services, be they 24-hour automatic banking services or advanced medical techniques for organ transplants, expand consumer choice and the quality of life.

Third, a competitive economy offers more job opportunities and increasing levels of employment at increasing real wage levels. Some people mistakenly see high wages as a competitive disadvantage for the U.S. But in fact, wages in the U.S. traditionally have been high because American business has been very productive, in that it has employed American labor more efficiently than have businesses in other countries. While wage increases that are out of proportion with productivity gains might put some industries at a disadvantage compared with firms that spend more money on capital improvements, in a competitive economy, labor is in strong demand, and workers enjoy high living standards. Thus, policies that "save" jobs in certain industries but sacrifice far more jobs in the rest of the economy defeat a major U.S. economic goal.

Any policy recommendation meant to improve America's competitive status must be judged in terms of these three goals: to increase the standard of living for Americans, to lead to expanded consumer

choices, and to increase employment opportunities. These goals can be met in a number of ways. First, and most important, businesses and industries can improve their productivity, that is, produce more goods and services at less cost. More efficient production techniques can be achieved through the introduction of new technology, better methods of industrial organization, cheaper sources of capital goods, or more efficient labor. These steps lower the costs of goods and services and boost quality. Second, inventions bring new products on the market for consumers and increase manufacturing efficiency. Third, the quick and efficient reallocation of capital and labor helps meet changing consumer and business needs at the lowest cost and in the most timely manner.

FALLACIES ABOUT U.S. COMPETITIVENESS

Competitiveness and the Trade Deficit

Much of the attention focused on competitiveness centers on the trade deficit. Many policy makers believe that trade deficits indicate that U.S. businesses cannot sell their products overseas and cannot compete with foreign imports. Yet the trade deficit does not, of itself, mean that the U.S. economy is becoming less competitive. Steps designed to reduce the trade deficit artificially, such as protectionism or export subsidies, will do nothing to improve competitiveness. The recent high value of the dollar was a result mainly of U.S. economic strengths, including a high growth rate, rising employment, and the promising future of the U.S. economy compared with other world economies. During periods of economic expansion, a country often attracts more imports, which often produces trade deficits. During the Depression of the 1930s, by contrast, the U.S. ran a trade surplus. Further, a strong economy attracts foreign capital, which among other things, makes it easier to purchase imports. A trade deficit, in other words, is not a sign of competitive weakness, as such.

U.S. Share of International Trade

Many policy makers also assume a country's competitive position is linked to the percentage of world exports the country's industries supply. Yet America's share of world exports is not a good indicator of its competitive status. After World War II, the U.S. stood alone as the great global exporting manufacturer while other industrial nations were rebuilding their economies. It was to be expected that, as other countries began to produce and trade, the U.S. share of world trade would decrease. But as total world trade expanded in absolute volume, U.S. exports in real terms also continued to expand. The entry of new producers into the world market was not a threat to American prosperity. Quite the contrary. Increased production meant that foreigners had more to offer in exchange for U.S. goods, and

American consumers benefited from the availability of new, imported foreign products.

The U.S. share of world manufacturing trade in fact has declined very slowly in the past two decades, dropping from 14.8 percent in 1962 to 12.3 percent in 1982. The U.S. is still a world leader in many exports, such as aerospace products, computer systems, office equipment, and food. During the same period, the share of world exports produced by the major European countries fell from 44.5 percent to 40.7 percent, while Japan's share of manufacturing exports rose from 5.6 percent to 12.2 percent.[2]

Admittedly, U.S. exports in constant dollar terms have been weak over the last few years. Merchandise exports rose out of the recessionary slump from $201.8 billion in 1983 to $219.9 billion in 1984. But in 1985, exports slipped to $214.4 billion.[3] The 1986 figure is likely to be only slightly higher than that. Yet these stagnant exports have been caused in large part by the previous high value of the dollar against other major currencies and by the slow growth rates in other countries. Low growth in foreign countries means less demand for U.S. goods. The continuing debt crisis in Latin America has robbed the U.S. of an especially important market. It is necessary to look more closely at U.S. industry to determine whether U.S. competitiveness problems have contributed to the export problems.

Import Penetration

Import penetration is offered by some as a sign of a country's competitive standing. It is assumed that, if a larger share of a country's goods are purchased abroad, that country must be growing less competitive. This is questionable. If American businesses acquire such capital goods and production materials as steel, lumber, or computer chips more cheaply from overseas, they can produce goods for less and offer their goods and services at lower prices to Americans and to overseas customers. And if U.S. consumers can purchase less expensive foreign goods, American capital and labor are freed for the production of other goods and services, meaning a higher standard of living for Americans. Thus increased import penetration can mean greater productivity, prosperity, employment, and competitiveness.

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2. U.S. International Competitiveness: Perception and Reality (New York: New York Stock Exchange, Office of Economic Research, August 1984), p. 12.

3. Joint Economic Committee, Economic Indicators, December 1986 (Washington, D.C.: U.S. Government Printing Office, 1986), p. 36. Calculation includes civilian and non-civilian employees.

Manufacturing versus Service Jobs

Job creation in the U.S. in recent years has been stronger than in any other developed country. Since 1982 the U.S. economy has generated 10 million net new jobs,[4] and since 1975 the real employment level has increased by nearly 25 million.[5] During this same period, the European Community created no net new jobs.

Some policy makers contend that, because many of these new jobs are in the service sector, the U.S. is slipping in competitive status. They fear that employment will grow only because Americans once working at high paying jobs in auto or steel plants are forced to work at low-wage service jobs, such as retailing.

The service sector includes a wide variety of jobs, from hamburger stand employees to lawyers. There are many higher paying service sector jobs, such as computer technicians and software specialists, accountants, and health care workers. Further, as services become a more important part of the employment picture, wages (and real purchasing power) in this sector will increase. And already, wages in some manufacturing jobs have declined. For example, wages for many steel workers, kept artificially high in the 1970s due to trade barriers, are going down.

Because a great proportion of new jobs are in services, certain areas of the service sector might appear to have lower wages because new workers in any sector begin at lower rates. Over time, salaries in these areas of the service sector should improve. The service sector also includes the majority of part-time workers, such as teenagers working after school or mothers with children. These factors make wages in the service sector as a whole appear lower than in manufacturing, which has fewer part-time workers. But for year-round, full-time service sector workers, the average annual salary in 1984 was $21,731, compared with $22,184 for all industries and $23,668 for manufacturing firms.[6]

It is also said that a service-oriented U.S. economy could pose serious trade problems. To purchase goods from abroad, Americans must offer something in exchange. Some critics fear that increased exports of such services as banking, accounting, marketing, and data processing will not make up for losses in manufacturing exports; they

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4. Ibid., p. 11.

5. Council of Economic Advisers, Economic Report of the President (Washington, D.C.: U.S. Government Printing Office, February 1986), Table B-31, pp. 288-289.

6. Lynn E. Brown, "Taking In Each Other's Laundry--The Service Economy, New England Economic Review, July/August 1986, Table 3, p. 23.

maintain that the dollar value of trade in services will never equal the dollar value of manufacturing trade.

The evidence does not support these concerns. While employment in the manufacturing sector has declined as a percentage of Gross National Product (GNP), from 24.8 percent in 1960 to 16.2 percent in 1984, manufacturing production as a share of GNP has remained steady at around 20 percent. This has happened because of the productivity gains that enable fewer workers to produce a greater quantity of goods. As the Table below indicates, manufacturing as a percentage of American GNP has gained slightly over the last few years. The fact that a smaller percentage of the work force produces the same percentage of manufactured goods indicates that the U.S. economy has grown more efficient, not less competitive.

Manufacturing Employment and GNP

Year	1960	1965	1970	1975	1980	1981	1982	1983	1984
Manufacturing as as a percentage of total employment	24.8	24.7	23.9	20.9	20.1	19.8	18.6	18.0	16.2
GNP produced by manufacturing as a percentage of total GNP	20.3	22.2	21.0	20.3	20.9	20.8	20.0	20.7	21.8

Source: Calculations for employment based on Economic Report of the President, Table B-31 and B-40. Calculations for manufacturing as a percentage of GNP based on Table B-11, in 1982 dollars.

LEGITIMATE PRODUCTIVITY CONCERNS

Concern for America's competitive status should focus on U.S. productivity. The more efficient American business and labor become, the more they can produce, either to consume at home or to trade for goods from other countries. Concerns about the trade deficit as such, about U.S. shares of given international markets, or about manufacturing versus service jobs are inappropriate. The goal of competitiveness policy should be to improve standards of living, consumer choice, and job opportunities through increased productivity.

While there have been improvements in the last few years, over the last several decades, the U.S. has lagged behind other major industrial powers in productivity gains, in terms of increased output per hour worked. This is a real cause for concern. Between 1960 and 1983, the U.S. annual increase in productivity averaged only 1.2 percent, compared with annual gains of 3.4 percent for Germany and 5.9 percent for Japan.[7] Foreign competitors have become more efficient than their U.S. counterparts. For example, the Japanese auto industry has enjoyed real production cost advantages.

Yet U.S. manufacturing output per worker is still high in absolute terms. Each American worker produced approximately $31,500 in goods in 1981, for instance, compared with $23,700 that year for each Japanese worker and $24,900 per German worker.[8] And in recent years, because of the threat of foreign competition as well as tax cuts and less government regulation, the trend toward low productivity growth has reversed. Recently U.S. productivity has been accelerating, rising to a 1982 and 1983 average of 2.5 percent, compared with 3.4 percent for Germany and only 1.4 percent for Japan.[9]

In terms of overall industrial production, the U.S. has realized increases since 1977 that are greater than any of its major industrialized competitors except Japan. In 1984 U.S. industrial production stood at 121.8 percent of its 1977 level. Japan, reaching 138.9 percent, bettered its own 1977 level and the U.S. rate of growth. In 1984 Canada reached only 111.8 percent of its 1977 level, and the European Community, only 106.8 percent.[10]

Even without federal government action, this trend will probably continue. Yet to ensure future growth, political leaders must understand the factors that have hindered productivity gains in the past, and formulate new competitiveness policies accordingly. Among past problems:

Labor-Management Relations

Because labor is a key and indispensable part of the production process, labor-management relations have an important effect on a country's productivity. In the U.S., these relations have tended to

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7. Global Competition, Volume I, p.. 11.

8. Organization for Economic Cooperation and Development (OECD), Labor Force Statistics, 1983; OECD Historical Statistics, 1983. Cited in Global Competition, Volume II, p. 46.

9. Cited in Global Competition, Volume II, p. 111.

10. Economic Indicators, op. cit., p. 35.

be adversarial. In Germany and Japan, on the other hand, a more cooperative relationship has boosted productivity. An Organization for Economic Cooperation and Development study found that, for each 1,000 workers, 813 days in the U.S. are lost each year due to labor unrest. In Japan, only 31 days are lost each year per 1,000 workers, and in Germany, only 6 days lost for this reason.[11]

In many U.S. industries, management has attempted to purchase labor peace with wages not justified by productivity gains. Such wage increases in the 1970s, for example, made steel workers among America's highest paid industrial employees. But failure to invest in technological improvements during this period meant that steel-making productivity declined. As a result, by the 1980s, the U.S. steel industry has become more uncompetitive and has been forced to lay off thousands of overpaid workers.[12]

Another general problem in the U.S. is that wages cannot easily be reduced in difficult economic times. Thus if a firm must cut labor costs to boost efficiency, it can only cut jobs, not wages. The Japanese approach to this problem is very different. Many Japanese workers receive a substantial portion of their wages as bonuses tied to the productivity and profitability of their companies. Thus, Japanese wages are flexible. When profits are down, bonuses drop; layoffs, however, are avoided. This system gives incentives to employees to work hard and efficiently. The more profitable the company, the larger their bonuses.

U.S. Business Culture

It is often said, correctly, that many American firms pursue narrow and shortsighted business strategies, preferring immediate profits to long-term gains and paying insufficient attention to foreign markets. This attitude derives in part from past U.S. successes. In the decades after World War II, American industry was the most efficient in the world, with few foreign countries able to match it. In addition, most American products were sold exclusively in the huge U.S. market. Both exports and imports were on average only about 6 percent of GNP, much smaller than in other countries. Little attention, therefore, had to be paid to the specific needs of foreign customers.

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11. European Management Forum, from OECD Historical Statistics, 1983; International Labor Organization; Bulletin of Labor Statistics, 1983; Japan Labor Bulletin, November 1982. Cited in Global Competition, Volume II, p. 47.

12. See Kent Jones, "Saving the Steel Industry," Heritage Foundation Backgrounder No. 354, May 21, 1984.

Today the situation is changed. Trade accounts for twice as much of America's GNP as it did two decades ago,[13] and foreigners challenge American firms worldwide. Many U.S. industries have been slow to meet this new challenge,[14] often because they tend to seek quick profits rather than to concentrate on the long term. Japanese firms, on the other hand, will often lose money for years in a foreign market but will persevere and eventually dominate the market. In addition, American business representatives tend to have poor language skills, often relying on their customers to learn English. Many are ignorant of the culture and customs in their overseas markets. Therefore, even with the falling value of the dollar, they often fail to seize opportunities to expand their sales.

Government Regulations

U.S. laws and regulations also tend to hold back American productivity. Business costs climb, for example, when the government mandates new worker benefits beyond what profits and productivity gains otherwise would allow. Many environmental regulations make only marginal reductions in pollution while adding to the cost of doing business.[15] Moreover, environmental and other regulations often force efficient and responsible businesses to shoulder the costs imposed by irresponsible firms. The new Superfund law, for instance, levies a tax on many businesses to pay for hazards resulting from the activities of a very few firms.

Antitrust laws, too, can discourage business cooperation and penalize U.S. firms for honest business success.[16] Foreign firms generally do not face such restrictions from their own governments. Some policy makers fear that, if U.S. businesses are too large, or if they cooperate too closely with one another, they will be able to take advantage of the consumer. But since 70 percent of U.S. goods are subject to foreign competition, American firms that raise prices beyond what the public is willing to pay will find their customers turning to overseas suppliers. On the other hand, cooperation among U.S. firms could help them to compete more effectively with firms in other countries.

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13. Calculation based on Economic Report of the President, Table B-1 and B-99.

14. As an example, see the review of auto industry problems in David Halberstam, The Reckoning (New York: William Morrow and Co., 1986)

15. See, Richard B. McKenzie, ed. A Blueprint for Jobs and Industrial Growth (Washington, D.C.: The Heritage Foundation, 1983) for examples, pp. 63-69.

16. See Edward L. Hudgins, "36 Ways to Narrow the U.S. Trade Deficit," Heritage Foundation Backgrounder No. 457, September 24, 1985, pp. 8-11.

Uncertainty concerning U.S. business regulations also harms U.S. competitiveness by making planning difficult and by discouraging risk taking and innovation. In the 1970s, for example, regulations in the auto industry often changed from year to year. U.S. car manufacturers thus were reluctant to invest in long-term improvements, not knowing what actions would be forthcoming from Washington.

The Cost of Capital

Capital investment is essential to a country's productivity. Capital allows new machines and technologies to be introduced and new products developed. Yet the cost of capital in the U.S. is higher than in other advanced countries. One calculation finds that between 1961 and 1983, real, inflation-adjusted capital costs varied between 13 and 20 percent in the U.S., compared with a range of 6 to 10 percent in Japan.[17] In the 1970s, the high cost of capital was caused in large part by high tax rates and by the inflationary policies of the Federal Reserve Board, which boosted interest rates. Today, the attractiveness of U.S. business investments in part accounts for the greater demand for capital, and thus its higher costs. But massive federal spending diverts capital from the productive private sector and raises capital costs well above what they would be otherwise. While U.S. interest rates have dropped recently, real capital costs still are higher than in most other industrialized countries.

The supply of capital in the U.S. also is lower than in many competing countries. Savings in the U.S. has averaged 5 percent of GNP over the last decade. In Japan, savings has averaged nearly 18 percent, meaning a larger capital pool for investors.[18]

The volume of funds used by U.S. businesses for investment also lags behind other countries. Capital formation in the U.S., that is, fixed investment as a share of GNP, averaged only 18.1 percent between 1960 and 1983, lower than any industrialized country save Britain, which averaged 18 percent. In Germany, capital formation during the same period averaged 23.4 percent of GNP, while in Japan, the share was 32.3 percent.[19] The low savings and investment in the U.S. have been caused in part by U.S. tax policies that penalize businesses with double taxation--once when profits are posted at the corporate level,

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17. George N. Hatsopoulos, "High Cost of Capital: Handicap of American Industry," American Business Conference and Thermo Electron Co., 1983, with January 17, 1984 update. Cited in Global Competition, Volume II, p. 113.

18. Global Competition, Volume II, p. 114.

19. Ibid., p. 112.

and again, when the same profits are distributed to owners and shareholders.

The high cost and relatively low volume of capital investment in the U.S. is a direct result of U.S. government economic and fiscal policies. The federal government consumes nearly 24 percent of the GNP, and this must be paid for either through borrowing or higher taxes. Both take capital away from the productive sector.

CONCLUSION

An acceleration in productivity is the key to improving the competitiveness of the U.S. economy. In past decades, U.S. productivity growth has lagged behind growth in other countries. In recent years, this trend has reversed and American businesses have realized important gains in efficiency.

The current public dialogue on competitiveness is useful, for it focuses attention on the need for freer markets and warns against repeating past policy mistakes. Two counterproductive "solutions" are frequently put forward to deal with America's competitive difficulties. The first is trade protectionism. By erecting a shield against competition, it reduces the best incentive for improved productivity. Protectionism would lower America's standard of living, create net unemployment, and hinder innovation and efficiency gains.

The second flawed solution is national industrial planning.[20] There is no indication that government bureaucrats are better able to make efficient economic decisions than are businessmen and consumers. And special incentives to exporters, paid for by other firms, confuse apparent symptoms with real causes, which would only dampen productivity further. In fact, government attempts to regulate business are in large part responsible for current problems.

The best approach to America's competitiveness problems is to create an economic environment that encourages and rewards innovation and risk taking and cuts unnecessary business costs. Among the steps needed:

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20. See Don Lavoie, National Industrial Planning: What Is Left? (Washington, D.C.: The Cato Institute, 1985), for a good overview.

1) Repeal laws that contribute to labor-management tensions and avoid new laws that add to labor costs while making labor markets less flexible.

The Labor Management Relations Act of 1947 prohibits employers from contributing financial or other support to labor organizations. This ban on company unions is an example of the sort of law that often creates labor-management tension and deprives many workers, the majority of whom are nonunion, of the benefits of a worker organization. In Japan, allowing businesses to contribute to labor organizations has led to greater cooperation between labor and management and benefited both parties. The U.S. law prohibiting such cooperation should be repealed.

Recent suggestions to create so-called worker rights to retraining or reemployment services, to be paid for in all likelihood by higher taxes on businesses and workers, also would make U.S. companies less competitive. Suggestions that businesses be required to notify the government and to obtain approval for plant closings, using government-labor-management tripartite councils to direct the process, would create rigidity in the labor market and lead to massive unemployment and skyrocketing inefficiency. Such solutions should be avoided.

2) Accelerate business deregulation.

There are several regulatory changes that would allow American businesses to compete better in world markets. Antitrust laws should be amended, for instance, to encourage efficient restructuring and research cooperation. Environmental laws that add huge costs to businesses while achieving only marginal reductions in pollution levels should be modified.

3) Lower the cost of capital by further budget cuts and tax reform.

Capital is the foundation of a competitive, free enterprise system. Government transfers of hundreds of billions of dollars from one interest group to another harm everyone in the long run. Politicians must recognize that their own spending policies are a major cause of America's economic difficulties. Similarly, Congress must pay closer attention to the impact of taxes on business decision making. The new tax law helps, but more reforms are needed. In particular, the double taxation of corporate profits should be stopped and corporate tax rates cut further.

The U.S. is still the freest and richest country in the world. But other countries are gaining on the U.S., not simply because of their own economic growth but because of American default. Economic growth in other countries does not threaten America. Indeed, a more

prosperous world offers U.S. businesses and consumers greater opportunities. But the federal government must remove the barriers to economic growth. Then the U.S. can continue to realize higher standards of living, greater consumer choice, and more employment opportunities.

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